CHOOSING THE FORM OF BUSINESS ORGANIZATION

TAX AND NON-TAX CONSIDERATIONS

INTRODUCTION

One of the fundamental initial decisions a new business owner faces is choosing the form of organization for the business. Generally speaking, a person should consider himself or herself to be “in business” once they have begun the operation of an activity for which they expect to be paid. This is true whether or not that person terminates other employment (such as a job that brings a paycheck), or intends to operate that business on a seasonal or short-term basis. For most businesses, the choices are:

Sole Proprietorship. In a **sole proprietorship**, the business is owned and controlled by one individual. This person alone receives the profits and bears the losses from the business, and this person alone is responsible for the debts and obligations of the business. Income and expenses of the business are reported on the proprietor’s individual income tax return, and profits are taxed at the proprietor’s individual income tax rate. If a husband and wife wish to own a business together, they must either form a partnership, corporation or limited liability company (in order to have each of them be an owner of the business) or a sole proprietorship (in which case only one of them will be an owner of the business).

A married couple who jointly operate an unincorporated business and who file a joint federal income tax return may have a qualified joint venture and can elect not to be treated as a partnership for federal tax purposes provided that the husband and wife are the only members of the joint venture and that both husband and wife materially participate in the running of the business. In this case each spouse will report his or her share as a sole proprietorship.

Partnership. A **general partnership** is a business owned by two or more persons who associate to carry on the business as a partnership. Partnerships have specific attributes, which are defined by statute. All partners in a general partnership share equally in the right, and responsibility, to manage the business, and each partner is responsible for all the debts and obligations of the business. Distribution of profits and losses, allocation of management responsibilities, and other issues affecting the partnership usually are defined in a written partnership agreement. Income and expenses of the partnership are reported on federal and state “information” tax returns, which are filed by the partnership. These include Schedules K-1 which are used to report to the partner’s respective shares of partnership taxable income. The partners then report this income on their separate tax returns along with their other income and pay tax at their applicable income tax rates.

Minnesota partnerships are formed and governed only by the Revised Uniform Partnership Act (RUPA), Minn. Stat. Chapter 323A. Partnerships formed under former partnership law are now subject to this chapter. If you were formed under former laws and have not yet consulted with an attorney about the changes in partnership law, you are encouraged to do so immediately.

A **limited partnership** is a type of partnership in which the limited partners share in the partnership's liability only up to the amount of their investment in the limited partnership. By statute, the limited partnership must have at least one general partner and one limited partner. The general partner has the right and responsibility to control the limited partnership, and is responsible for the debts and obligations of the limited partnership. In Minnesota, a limited partner may participate in the management and control of the limited partnership without losing limited liability protection but does not have the power to act for or bind the limited partnership (unless this is provided for in a separate agreement). Limited partnerships must be established in compliance with statutory requirements, including requirements of tax and securities laws. Because of their complex nature, limited partnerships should not be undertaken without competent professional advice.

Limited Liability Partnership and Limited Liability Limited Partnership. A general partnership may register as a **limited liability partnership (LLP)** by filing a limited liability partnership registration. In limited liability partnerships, the personal assets of the partners are shielded against liabilities incurred by the partnership in tort or contract situations. This is different from a non-LLP general partnership, in which partners may be personally liable to an unlimited extent for the debts and obligations of the partnership. It should be noted that limited liability partnerships are a relatively new type of entity and certain aspects, such as tax aspects, of such entities are not yet fully developed or understood.

Limited liability partnership status affords protection to the individual partner from liability for partnership obligations in tort and contract. An LLP files with the Secretary of State an annual report. There is a one-year grace period for retroactive reinstatement after revocation of LLP status for failure to file the annual report.

Limited liability partnerships must have a name that includes one of the following: "Registered Limited Liability Partnership," "Limited Liability Partnership," "R.L.L.P.," "L.L.P.," "RLLP," or "LLP. This should be used by the partnership in transactions with third parties so that they are aware of the partnership's status.

Minnesota law also allows a limited partnership to elect limited liability status under Minn. Stat. Chapter 321 by so designating this status in its certificate of limited partnership. This extends limited liability protection to both general and limited partners. This type of limited partnership is called a limited liability limited partnership. Limited liability limited partnerships are discussed below.

Care should be taken in naming a limited liability limited partnership; the name must contain the phrase "limited liability limited partnership" or the abbreviation "LLLP" or "L.L.L.P.", which must be part of the name, and must not otherwise contain the abbreviation "L.P." or "LP."

Corporation. A corporation is a separate legal entity. It is owned by one or more shareholders. The corporation must be established in compliance with the statutory requirements of the state of incorporation. The shareholders elect a board of directors which has responsibility for management and control of the corporation. Because the corporation is a separate legal entity, the corporation is responsible for the debts and obligations of the business. In most cases, shareholders are insulated from claims against the corporation.

It is worth noting here that because a corporation is an entity separate from its owners, if the owner (and/or members of the owner's family) performs services for the corporation, these persons are considered to be employees of the corporation. Thus, the corporation will be required to comply with most of the laws and regulations and reporting requirements applicable to employers.

The corporation may be taxed under Subchapter C of the Internal Revenue Code (a "C corporation") or the provisions of Subchapter S of the Code (an "S corporation"). Minnesota tax laws provide for comparable treatment.

A C corporation reports its income and expenses on a corporation income tax return and is taxed on its profits at corporate income tax rates. The Minnesota corporate franchise tax, sometimes called an income tax, is based on the portion of a C corporation's income that is allocated to Minnesota. Profits are taxed without regard to payment of dividends, which generally are not deductible. Dividends paid to shareholders are taxable income to them. This is sometimes referred to as "double taxation" because this effectively taxes operating income twice, once to the corporation and then again when distributed to the owners, although it actually is two separate taxpayers being taxed on their separate income.

An S corporation election may be made by the shareholders of the corporation if the corporation meets the statutory requirements for S corporation status. An S corporation that has not previously been taxed as a C corporation is taxed in much the same manner as a partnership, i.e., the S corporation files an information return to report its income and expenses, but it generally is not separately taxed. Income and expenses of the S corporation "flow through" to the shareholders in proportion to their shareholdings, and then are taxed to them at their individual rates. Under the Internal Revenue Code, an S corporation may have only one class of stock (i.e., "common" stock, although voting differences are permitted), no more than 100 shareholders, and no shareholders that are nonresident aliens or non-individuals (e.g., corporations, partnerships, limited liability companies) except for certain estates, trusts, and certain tax exempt entities. The federal 2004 American Jobs Creation act allows an S corporation to treat shareholders within six generations of one family as one shareholder thus allowing family business S corporations to distribute shares to family members of existing shareholders without those new shareholders being counted as new shareholders against the 100 shareholder limit. S corporations are described in more detail in later sections of the Small Business Assistance Office publication, *A Guide To Starting A Business In Minnesota*. (If the shareholders of an existing C corporation elect to have it taxed as an S corporation additional rules as well as corporate level taxes may come into play. Any such change in tax status should be discussed in advance with a competent tax advisor.)

A **closely held corporation** is any corporation whose shares are held by a relatively small number of shareholders. The Minnesota Business Corporation Act defines a closely held corporation as one which does not have more than 35 shareholders. Most closely held corporations are relatively small business enterprises, in which all shareholders tend to be active in the management of the business. Some states provide a separate, less formal, less restrictive set of laws for closely-held corporations. Minnesota does not. In Minnesota, the business corporation law is geared to small corporations, so a separate law is not necessary, and all corporations operate under one law.

Limited Liability Company. A Minnesota business also may organize as a limited liability company. A limited liability company may have one or more members. As described further in the section on tax considerations in choosing the form of organization, under Treasury Regulations regarding entity classification the members of limited liability companies have some flexibility with respect to the federal income tax treatment of their entities. Under these rules a limited liability company with more than one member will be taxed as a partnership unless it elects to be taxed as a corporation and a limited liability company with only one member will be taxed as a sole proprietorship (a "disregarded entity") unless it elects to be taxed as a corporation. The applicable Regulations appear in 26 C.F.R. § 301.7701-1, et. seq.

A limited liability company that is taxed as a partnership or as a corporation must obtain its own tax ID numbers. A limited liability company with only one member that is taxed as a sole proprietorship generally does not need to obtain separate federal or state tax identification numbers unless it has employees or pays federal excise taxes, in which case it will obtain tax ID numbers and use them to remit employment taxes or pay excise taxes.

Business income and losses of a limited liability company that is taxed as a partnership or as a sole proprietorship are passed through to the members, included in their taxable income, and taxed at each member's income tax rate. As with a corporation, liability for business debts and obligations generally rests with the entity rather than with the individual owners. A limited liability company is not subject to many of the restrictions that apply to S corporations (unless it elects to be taxed as a corporation and wishes to be taxed as an S corporation). All members of a limited liability company may participate in the active management of the company without risking loss of limited personal liability. Minnesota adopted a new Limited Liability Company Act (Minn. Stat. Chapter 322C) that became effective August 1, 2015. Minnesota limited liability companies formed on or after that date are subject to the new act, and may be managed by the members, by a board of governors, or by a manager.

Other Forms of Organization. Other forms of organization available to Minnesota businesses include professional organizations, cooperative associations, business trusts, and certain variations of these forms of organization. These types of organizations are established and regulated by statute and involve complex legal, financial and accounting issues. Organizing under any of these forms should not be attempted without competent professional advice. Because of their highly specialized nature, these forms of organization are not addressed in detail in the *Guide*.

Changing the Form of Organization. Note that although the discussion in the above paragraphs is also applicable when changing the form of business organization, (e.g., when converting a sole proprietorship to a corporation), a business owner is strongly urged to seek professional assistance when doing so, because unintended consequences may result, often including significant tax consequences. For example, contracts entered into by the business may or may not be assignable to the new entity. Also, there may be tax costs to changing the form of organization, such as when an S corporation becomes a C corporation. Minnesota law also authorizes conversions in either direction between corporations and limited liability companies (including with organizations from other states that permit conversion from or into a Minnesota entity). The converting organization must adopt a plan of conversion that must be approved governors in accordance with the entity's governing statute. Upon approval, articles of conversion are drafted and filed with the Secretary of State who then will issue a certificate of conversion and a certificate of incorporation or certificate of organization if the resulting organization is a Minnesota corporation or limited liability company. Again, these changes can produce significant tax consequences and should be undertaken only when these are fully understood. For example, a conversion of a corporation into a limited liability company that is taxed as a partnership is treated for income tax purposes as a taxable liquidation of the corporation, which can produce taxable gain to both the corporation and its shareholders.

NON-TAX FACTORS IN CHOOSING THE FORM OF ORGANIZATION

In choosing the most appropriate form of organization, the business owner will want to consider a variety of factors, including: complexity and expense of organizing the business; liability of the business owner; distribution of profits and losses; management control and decision making; financing startup and operation of the business; transferability of ownership interest; continuity of the business entity following withdrawal or death of an owner; complexity and expense of terminating or reorganizing the business; extent of governmental regulation, and tax considerations.

These factors should be examined carefully in light of the objectives of the business owner. Competent legal, accounting and tax professionals can provide valuable advice and assistance in selecting the most appropriate form of organization.

As with many business decisions, choosing a form of organization involves weighing the advantages and disadvantages of each alternative before selecting the form most appropriate to the business owner's situation. No one form of organization will be appropriate to all situations, and as the business expands a change in the form of organization may be necessary. The discussion which follows examines the differences in each of the above factors for proprietorships, partnerships, corporations, and limited liability companies.

Complexity and Expense of Organizing the Business

All businesses, regardless of their form, will encounter certain organizational costs. These costs can include developing a business plan, obtaining necessary licenses and permits, conducting market research studies, acquiring equipment, obtaining the advice of counsel, and other costs.

Sole Proprietorship. The sole proprietorship is the simplest form of organization, and the least expensive to establish. There are no statutory requirements unique to this form of organization. From a regulatory standpoint, the business owner only needs to obtain the necessary business licenses and tax identification numbers, register the business name, and begin operations. Many individuals begin their business as a sole proprietorship. As the business expands or more owners are needed for financial or other reasons, a partnership or corporation may be formed.

Partnership. A **general partnership** is more complex to organize than a sole proprietorship, but involves fewer formalities and legal restrictions than a limited partnership, corporation, or limited liability company. Basic elements of partnership law are established by statute, but most issues can be determined by agreement of the partners. A written partnership agreement is highly recommended, but is not legally required. Factors to consider in a partnership agreement are listed in a later section of the *Guide*. The partnership agreement is not required to be filed with any governmental entity. Note that under the Revised Uniform Partnership Act (RUPA) of 1997, Minn. Stat. Chapter 323A, partnerships have the option of filing with the Secretary of State certain statements regarding the authority and liability of partners as well as the status of the partnership.

A **limited partnership** must meet specific statutory requirements at the time of organization, and the offering of ownership interests in the limited partnership is subject to securities laws. Accordingly, the limited partnership often is more complex and expensive to organize than a general partnership.

Limited Liability Partnership and Limited Liability Limited Partnership. An existing general partnership may elect limited liability partnership status by filing a limited liability partnership registration with the Secretary of State. Such registration is effective for an indefinite period of time. Limited liability limited partnerships are also permitted. Anyone interested in forming an LLP or an LLLP is advised to seek the advice of counsel. Note also under applicable statutes, limited liability status has an indefinite term, although the Secretary of State will revoke LLP or LLLP status if the required annual registration is not filed. Limited liability partnerships and limited liability limited partnerships generally follow the basic partnership or limited partnership law with specific exceptions as provided by law.

Corporation. The corporation is a formal and complex form of organization, and accordingly can be expensive to organize. Procedures and criteria for forming the corporation and for its governance are established by statute. **FAILURE TO FOLLOW THE STATUTORY FORMALITIES CAN RESULT IN LOSS OF CORPORATE STATUS AND IMPOSITION OF PERSONAL LIABILITY ON THE INCORPORATORS OR SHAREHOLDERS.** The S corporation faces further complexity in that an election to be taxed as an S corporation for federal tax purposes must be filed with the Internal Revenue Service in a timely fashion. In addition, care must be taken in the transfer of shares not to inadvertently lose S corporation status.

Because of the complexities involved in incorporating, corporations often will make greater use of professional advisors, which will increase costs. Other costs associated with incorporating include filing fees, which are greater for corporations, and the costs associated with tax compliance and preparing various government reports. If the corporation does business in other states, it generally will be required to register to do business in those states, thus further increasing the cost and complexity of incorporation. And, if the corporation will raise capital by selling securities, the compliance costs involved will be substantial.

Minnesota has attempted to simplify the incorporation process by including in the Minnesota Business Corporation Act all of the rules pertaining to the internal governance of the corporation. A corporation that agrees to be governed as specified in the statute need only file standard form articles of incorporation with the Secretary of State. The corporation that wishes to vary the statutory requirements generally must do so in its articles of incorporation. Prior consultation with legal counsel can assist the incorporators in determining which approach is most appropriate for the corporation. Further information on incorporating appears in the section of the *Guide* titled Forming a Minnesota Business Corporation.

Limited Liability Company. The new Minnesota Revised Uniform Limited Liability Company Act takes a more partnership-like approach to these entities than did the prior Act. Nevertheless a limited liability company often will combine aspects of both partnerships and corporations. In many cases where the governance and economic rights are simple and allocated among the members equally, one can expect formation to be similar to a corporation in complexity and cost to organize. As with a corporation, the procedures and criteria for forming a limited liability company are specified by statute. **FAILURE TO FOLLOW THE STATUTORY REQUIREMENTS CAN RESULT IN LOSS OF LIMITED LIABILITY COMPANY STATUS AND IMPOSITION OF PERSONAL LIABILITY ON THE ORGANIZERS AND MEMBERS OF THE COMPANY**. There is very little case law to guide organizational and operational decisions, although Minnesota's current limited liability company law is modeled on the Revised Uniform Limited Liability Company Act, and the commentary to that may be helpful and can be found on the internet at http://www.uniformlaws.org/shared/docs/limited%20liability%20company/ullca_final_06rev.pdf. In addition, the Minnesota Revised Uniform Limited Liability Company Act contains default rules that will apply in the absence of an agreement by the member (for example, each member has equal management rights and the right to an equal percentage of nonliquidating distributions made by the limited liability company. Members of limited liability companies need to be familiar with these rules. They often will want a formal written agreement where their intentions differ from the law's default rules. For these and many other reasons, owners of a limited liability company may need to consult often with their professional advisors, increasing their costs.

Under the Treasury Regulations dealing with the federal income tax classification of business entities, the members of a limited liability company have some flexibility in choosing the tax status of their entity. Professional advice in this area is strongly encouraged.

As is the case for Minnesota corporations, members of a limited liability company may agree to have the company governed by the default provisions of the governing statute – Minn. Stat. Chapter 322C. In that case, standard form articles of organization may be used to organize the company. The law, however, permits the members of these entities to vary many of the default provisions of Minn. Stat. Chapter 322C through agreements called "operating agreements". While it is advisable in most instances to reduce an operating agreement to writing, that is not required. Like a partnership agreement, an operating agreement may be oral, in a record (e.g., in written or electronic format), implied by conduct, or in any combination thereof, as long as it is the agreement of all persons who are members when the agreement is entered into.

Further information on forming a limited liability company appears in the section of the *Guide* on Forming a Minnesota Limited Liability Company.

Liability of the Business Owners

Sole Proprietorship. The sole proprietor is personally liable for the debts of the business, even if those debts exceed the owner's investment in the business. All of the owner's assets – both those used in the business and personal property (subject to certain exemptions) – can be attached by creditors and sold to pay business debts. The sole proprietor may be able to minimize certain risks such as property loss, personal injury or product liability by obtaining adequate insurance.

Partnership. In a non-LLP **general partnership**, each partner may be personally liable for up to the full amount of the debts of the business, even if the debts exceed the owners' investment in the business. The partner with greater personal assets thus risks losing more than a partner with fewer personal assets. As with a sole proprietorship, many business risks can be lessened by obtaining adequate insurance.

However, in a Minnesota **limited liability partnership,** partners are not personally liable for the wrongful acts or omissions in the ordinary course of business of other partners, for the misuse of money or property of a non-partner by another partner, or for the debts or obligations of the partnership, subject to certain exceptions. It is uncertain how this kind of partnership will be treated in other states, although most states have adopted some form of limited liability partnership legislation.

In a **limited partnership**, so long as the statutory formalities are met and the limited partner is not relied upon by others as a general partner, the limited partner generally is not liable for the obligations of the limited partnership. Thus the limited partner risks loss only up to the amount of his or her investment. The general partner retains full liability as in any other partnership. In **limited liability limited partnerships** general partners will enjoy the same protections from liability enjoyed by limited partners or partners of an LLP.

Corporation. The corporation is a separate legal entity, and in most cases is the entity that is liable for the debts of the business. The shareholders generally are exempt from personal liability for those debts and thus risk loss only up to the amount of their investment in the corporation. This is true for both C corporations and the S corporations. It should be noted, however, that in a small, closely held or newly created corporation without an established credit history, some or all of the shareholders may be expected to personally guarantee repayment of certain corporate debts as a condition of obtaining a loan or credit.

Also, under certain circumstances such as fraud or personal wrongdoing, a court may "pierce" the liability shield and hold shareholders personally liable for wrongful acts. Finally, it is possible for courts to "disregard" the corporate entity and make shareholders liable under certain circumstances, especially where the corporation and the shareholders themselves have not respected the corporate entity by commingling corporate funds with those of other persons or having the corporation pay shareholder personal expenses out of corporate assets.

See the Withholding Tax Deposit and Filing Requirements information of the Income Tax Withholding section of the *e* for additional information on personal liability for payment of employment taxes.

Limited Liability Company. Liability of the owners of a limited liability company generally is the same as for shareholders of a corporation; that is, absent fraud, personal wrongdoing or disregard of the entity, they generally are not held personally liable for the debts and obligations of the business. They therefore risk loss only up to the amount of their investment. As is the case for corporations, owners of small, closely held, or newly organized limited liability companies may be required to give personal guarantees of repayment to secure financing or credit.

No Liability Protection for Personal Act. It is important to note that no entity structure will insulate the owner from liability for his or her own personal acts.

Distribution of Profits and Losses

Sole Proprietorship. The sole proprietor receives all the profits from the business, and bears all the losses, which may exceed the proprietor's investment in the business.

Partnership. In the general partnership, the limited liability partnership, the limited liability limited partnership and the limited partnership, profits and losses are passed through to the partners as specified in the partnership agreement. If left unspecified, profits and losses are shared equally among the partners.

Corporation. In a C corporation, profits and losses belong to the corporation. Profits may be distributed to shareholders in the form of dividends, or they may be reinvested or retained (within limits) by the corporation. Losses by the corporation are not claimed by individual shareholders. Shareholders include dividends and the gain or loss on the sale of stock or liquidation of stock in the corporation as income.

S corporation. In an S corporation, corporate income and losses flow through and are taxed to the shareholders in proportion to their shareholdings. Shareholders also include their gain or loss on the sale of stock or liquidation of stock as income. Generally cash distributions (dividends) received from the S corporation are not included in income to the extent the shareholder has basis in his or her stock.

Limited Liability Company. Profits and losses of a limited liability company flow are taxed in the same manner as those of a sole proprietorship, partnership, S corporation, or C corporation depending on how the entity has chosen to be treated for federal income tax purposes. The governing statute, articles of organization, or the operating agreement will specify how these are allocated among the members.

Management Control and Decision Making

Sole Proprietorship. The sole proprietor has full and complete authority to manage and control the business. There are no partners or shareholders to consult before making decisions. This form of organization gives the proprietor maximum freedom to run the business and respond quickly to day-to-day business needs. The disadvantage of this form is that the sole proprietor, as just one person, will have limited time, energy and expertise to devote to the business. His or her experiences may not provide the breadth of skills and knowledge necessary to deal with all phases of the business. Further, because the sole proprietor is the only person authorized to act on behalf of the business, he or she may be unable to leave the business for extended periods of time without jeopardizing its operations. As the business expands, the proprietor may be able to hire managers to perform some of these functions and provide additional expertise, but in the early years of the business, the sole proprietor often will perform many of these tasks alone.

Partnership. The general rule of management is that in both a **general partnership** and a **limited liability partnership**, all partners share equally in the right, and responsibility, to manage and control the business. The partnership agreement may centralize some management decisions in a smaller group of partners, but all partners continue to share ultimate responsibility for these decisions. By statute, unless a partnership agreement provides otherwise, certain management decisions require unanimous consent of the partners. Other decisions may be made by consent of a majority of the partners. The right to share equally in decisions can make the decision-making process cumbersome, and the risk of major disagreements can impair effective operation of the business. An advantage of the partnership that is not present in a sole proprietorship is that the partnership, with its several owners, can bring a broader range of skills, abilities and resources to the business. The owners' combined experiences also can promote more informed decision making. In addition, the workload can be shared to lessen the physical and other demands on the individual owners.

In addition, under the Revised Uniform Partnership Act (RUPA), a system of formal filings has been established that allows partnerships to limit the authority of certain partners to third parties as well as to limit the liability of partners for partnership obligations purportedly incurred by a partner after the partner has left the firm. In order to use this system, the partnership must first file with the Secretary of State an assumed name certificate or limited liability partnership statement of qualification. After that filing has been made, the partnership may again file any of the following statements with the Secretary of State:

- **Statement of Partnership Authority.** This allows the partnership to either restrict or specifically expand the authority of particular partners to conduct various transactions, particularly real estate transactions.
- **Statement of Denial.** This allows a partner to deny partnership status or the conferral of authority upon the partners by a Statement of Partnership Authority.
- **Statement of Dissociation.** This allows a partner who is withdrawing from the partnership to avoid liability for obligations for the partnership incurred after the partner has withdrawn, and also allows the partnership to eliminate the authority of that partner to bind the partnership.
- **Statement of Dissolution.** This allows the partnership to notify the world that it is dissolving and that partners will no longer have authority to act on behalf of the partnership.

The following are also permitted:

- **Statement of Merger.** This allows partnerships and limited partnerships to merge with each other.
- **Statement of Qualification.** This statement establishes a Minnesota limited liability partnership under Minn. Stat. Chapter 323A.
- **Statement of Foreign Qualification.** This statement registers a non-Minnesota limited liability partnership.

Any of these seven statements may also be amended or cancelled.

In order for any Statement to have an effect on real property transactions, a certified copy of the Statement, obtained from the Secretary of State, must be recorded in the office where land records for the county in which the real property is located, and, if applicable, has been memorialized on the certificate of title for that real property.

In a **limited partnership** in Minnesota, limited partners may participate in the management and control of the partnership but may not act for or bind the partnership (unless this is provided for in the limited partnership agreement or another agreement between the limited partner and the limited partnership). Those functions generally are performed by general partners.

Corporation. The rules for corporate decision making are established by statute, but many rules may be modified by the articles of incorporation or bylaws. Shareholders elect the board of directors, which in turn manages the operation of the business. The corporation also must have one or more natural persons exercising the functions of chief executive officer and chief financial officer. Except in very small corporations in which the shareholders are also the directors, shareholders as a group generally will not directly participate in management decisions. This concentration of decision making in a relatively few individuals promotes flexibility in decision making, but also can result in overruling of minority interests or in some cases manipulation or exploitation of minority shareholders. To resolve this problem, corporations may adopt provisions in the articles of incorporation or bylaws to give minority shareholders a stronger voice in management decisions. Decision-making authority also may be delegated by the shareholders and/or directors to hired managers, who may or may not be shareholders. This delegation further removes decision-making authority from the shareholders. Like a partnership, the corporation can draw on the skills and expertise of more than one individual in running the business. This can broaden the base of information for decision making and reduce workload demands on individual managers.

The articles of incorporation, bylaws or state business corporation act establish procedures and criteria for decision making, such as meeting and quorum requirements, voting margins, and the like, which may make decision making in the corporation more cumbersome than in a sole proprietorship or partnership.

Limited Liability Company. Minn. Stat. Chapter 322C, which governs limited liability companies takes more of a partnership approach to limited liability companies than did the older law, which was based on Minnesota's business corporations act. Minn. Stat. Chapter 322C permits management by the members, management by one or more managers, and management by a board (Minn. Stat. § 322C.0407). The default structure is member management. Unless the operating agreement provides otherwise, each member has equal rights in the management and conduct of the limited liability company's activities – i.e., per capita, not in proportion to their capital contributions. Differences as to matters in the ordinary course of the limited liability company's activities may be decided by a majority of the members, while acts outside the ordinary course may be undertaken only with the consent of all members. Additional agents (who can be referred to as officers) may be appointed by the members, managers, or board. As with a corporation, the rules governing the management of a limited liability company are often specified in a written operating agreement. If not otherwise specified in an operating agreement, the default rules of the limited liability company statute will control.

In addition, the Revised Uniform Limited Liability Act as adopted in Minnesota (Minn. Stat. Chapter 322C), provides for a system of formal filings similar to those under the Minnesota Revised Uniform Partnership Act. These allow limited liability companies to put of record the authority or limitations on authority of persons holding any position that exists in or with respect to the company to execute an instrument transferring real property held in the name of the company or enter into other transactions on behalf of, or otherwise act for or bind, the limited liability company. Such statements affect only the power of a person to bind a limited liability company to persons that are not members. Any such statement also may be amended or cancelled. Filing a statement of dissolution automatically cancels all previously filed statements. The types of statements and their effects may be found in the statute (Minn. Stat. § 322C.0302.)

In the case of real property transactions, if an effective statement containing a limitation on the authority to transfer real property held in the name of a limited liability company is certified by the Secretary of State and is recorded in the real property records, all persons are deemed to know of the limitation. An effective statement of authority that grants authority to transfer real property held in the name of the limited liability company, is conclusive in favor of a person that gives value in reliance on the grant without knowledge to the contrary, whether or not a certified copy of the statement was recorded in the real property records, unless, when the person gave value,

(a) the statement had been canceled or restrictively amended under and a certified copy of the cancellation or restrictive amendment had been recorded in the real property records, or (b) a limitation on the grant was contained in another statement of authority that became effective after the statement containing the grant became effective and a certified copy of the later-effective statement was recorded in the real property records.

Financing Startup and Operation of the Business

A startup business, regardless of form, generally will find it difficult to obtain outside financing. The statistical failure rate for new businesses is high, and many lenders view financing the startup business venture as extremely risky. Banks and other creditors generally will require a significant capital investment by the business owner, and a personal guarantee that the owner will repay the loan. Corporations may issue securities to pool capital from a large number of investors; however, the costs of complying with complex federal and state securities laws may be prohibitive, and there is no guarantee that a market will exist for the securities of a new firm. Likewise, limited liability companies may increase capital by admitting more members, but will need to offer prospective members some likelihood of return on their investment. Thus as a practical matter, startup financing for the new venture – whether it is a sole proprietorship, a partnership, a corporation or a limited liability company – often is limited to what the owner and others closely associated with the venture are able to raise.

The discussion which follows addresses the relative ease with which firms with established credit histories may be able to attract financing.

Sole Proprietorship. The sole proprietor's ability to raise capital generally is limited to the amount of debt he or she can personally secure. Accordingly, the sole proprietorship ordinarily will have less capital available to finance operations or expansion than will other forms of organization that may be able to attract outside investors.

Partnership. In most cases, a partnership will be able to raise capital more easily than a sole proprietorship, but not as easily as a corporation. The borrowing power of each partner may be pooled to raise debt capital, or additional partners may be admitted to increase this pooled borrowing power. Or, if the partnership does not wish to distort the ownership position of the original partners, a limited partnership may be established to raise capital. While partnership assets may be accepted as collateral by a lender, the separate assets of individual partners are often needed to secure loans, either through loans made to the partners in their individual capacity or loans to the partnership that are guaranteed by individual partners, often with pledges of individual assets as security.

Corporation. The corporation generally is the easiest form of organization for raising capital from outside investors. Equity capital may be raised by selling stock to investors. As noted in the section of the *Guide* on securities registration, the sale of securities is regulated by federal and state laws. Due to the complexity of these laws, the sale of securities is expensive, and the cost may be prohibitive for startup firms. Long-term financing by lending institutions is easier for a corporation to structure because corporate assets may be used to secure the financing. Personal assets of the principals of the corporation and its shareholders also may be used to guarantee loans to the corporation.

The number of shares of stock a corporation may issue must be authorized by the articles of incorporation. If a corporation has issued all of its authorized shares, it is necessary to amend the articles of incorporation to authorize additional shares. The amended articles of incorporation must be filed with the Secretary of State, and a filing fee paid. The corporation can avoid these additional costs by authorizing a large number of shares at the time of incorporation.

S Corporation. An S corporation is limited by restrictions on who can be owners as well as the single class of stock rule which requires it to allocate profits and losses proportionately. This may limit the financing alternatives available to the S corporation.

Limited Liability Company. The limited liability company is financed by contributions from members. The limited liability company offers more flexibility in structuring outside financing than does the S corporation. The limited liability company may create multiple classes and series of membership interests, and may provide in its operating agreement (or its articles of organization) that profits and losses may be allocated other than under the default rule of per capita among the members. Unless the operating agreement provides differently, distributions by limited liability companies formed under Minn. Stat. Chapter 322C that are made before dissolution and winding up are to be in equal shares among members (i.e., per capita), and upon dissolution and winding up are to be made first to return prior contributions that have not been previously returned and then in equal shares among members and dissociated members. (Tax counsel should be consulted on the tax consequences of a disproportionate allocation.)

The ability of a limited liability company to create additional membership classes or series of membership interests is typically governed by the operating agreement.

Transferability of Ownership Interests

Sole Proprietorship. A sole proprietor transfers ownership of the business by transferring the assets of the business to the new owner. The prior proprietorship is terminated and a new proprietorship is established under the new owner.

Partnership. The transfer of a partner's economic interest in a partnership is determined by the partnership agreement, or by statute if there is no partnership agreement. Unless permitted by the partnership agreement, no person may become a partner without the consent of all the other partners. If a partner attempts to transfer his or her interest in the partnership without such an agreement, the transferee does not become a partner but instead becomes entitled to receive the allocations of profit and loss and the distributions that the transferring partner otherwise would receive. A properly drawn partnership agreement will address the conditions under which an ownership interest may be transferred, and the consequences to the transferee and to the partnership.

Corporation. Ownership in a corporation is transferred by the sale of stock. A change in ownership does not affect the existence of the corporate entity. Technically, shares of stock in a corporation are freely transferable. As a practical matter, however, the market may be limited for shares of stock in a small corporation that is not publicly traded. In addition, shareholders in a new venture often will want to restrict the transfer of shares and thus may provide for transfer restrictions in the articles of incorporation, bylaws, or a buy-sell or redemption agreement. In an S corporation, shares of stock are also freely transferable, in theory. However, the S corporation election may be inadvertently terminated if the entity to which the shares are transferred does not qualify as an S corporation shareholder, so a buy-sell agreement or other form of transfer restriction is even more important in these situations.

Limited Liability Company. Membership rights in a limited liability company generally can be viewed as consisting of financial rights (referred to as the "transferable interest") – the right to share in the profits, losses and distributions of the limited liability company and other rights (rights to vote and to manage the business, information rights, etc.) Unless the operating agreement (or articles of organization) provides otherwise, a member may assign or transfer financial rights that comprise the transferable interest. Such a transfer gives the transferee all the rights to profits and distributions previously held by the transferor. Unless the operating agreement (or articles of organization) provides otherwise, a transfer does not create other membership rights in the transferee, nor can the transfer allow the transferee to directly or indirectly exercise governance rights, unless all other members give their consent. The operating agreement (or articles of organization) may provide for less-than unanimous consent.

Continuity of the Business Following Withdrawal or Death of an Owner

Sole Proprietorship. The business entity terminates at the death of the proprietor or if the proprietor becomes unable to manage it.

Partnership. General partnerships and **limited liability partnerships** under the Revised Uniform Partnership Act (RUPA) do **NOT** automatically cease to exist when a partner dies or otherwise withdraws from a partnership. The partnership continues, unless certain other events occur. A **limited partnership** does not terminate when a limited partner dies or becomes disabled. The limited partner's interest may be assigned, and if the limited partner dies, his or her legal representative may exercise all the partner's rights for purposes of settling the estate.

Corporation. A corporation is a separate legal entity, and therefore the death, disability or withdrawal of an owner has no legal effect on the business entity's existence. As a practical matter, however, many small businesses depend heavily on the efforts of one or two individuals, and the death or disability of one of those key individuals can seriously impair the economic viability of the business. For this reason, a small business corporation, like a partnership, often will obtain life insurance on key shareholder-employees. The articles of incorporation or a buy-sell or shareholder agreement may restrict the transferability of stock in order to retain control of the firm by the remaining key individuals.

Limited Liability Company. Limited liability companies governed by the new Minnesota Revised Uniform Limited Liability Company Act will not dissolve upon the termination of membership of a particular member unless specified in the operating agreement (or articles of organization) or, once a member has been admitted 90 consecutive days pass during which the limited liability company has no members. Otherwise, the termination of a member's interest does not affect the existence of the limited liability company.

Complexity and Expense of Terminating the Business

Sole Proprietorship. There are no federal or state regulations governing termination of the sole proprietorship itself. The sole proprietor simply winds up the affairs of the business and discontinues operations. If the business had employees, the owner must notify federal and state taxing authorities that the proprietor is no longer operating the business and paying employees.

See also the section of the *Guide* entitled "Business Taxes – Income Tax Withholding – Withholding Tax Penalties and Interest". The final report of income and expenses attributable to the business is included in the proprietor's individual income tax return, which is filed at the usual time. No final return or early filing is required. Tax consequences may flow from the sale or other disposition of assets used in the business.

Partnership. The partnership, because it is a more formal structure than a sole proprietorship, is more complex to terminate. RUPA identifies several ways in which dissolution may occur, but the partners may provide for continuation of the partnership even if an act of dissolution occurs. The consequences of causing the dissolution of a partnership also are specified in RUPA. The statute addresses the allocation and distribution of partnership property upon dissolution, liability of persons continuing the business, and other rights and liabilities of the partners. However, the statute does not address procedural matters such as filing final tax returns, notifying taxing authorities of the termination for employment tax purposes, notification of creditors and similar matters involved in winding up the affairs of the partnership. Assistance with these matters may be obtained from legal counsel. Tax consequences may apply to the disposition of partnership assets, and those tax consequences will flow through to the partners. The **general partnership** may file a Statement of Dissolution with the Secretary of State but generally otherwise need not file notice of dissolution or termination of the partnership with any governmental entity. The **limited partnership** must formally cancel the certificate of limited partnership and file the cancellation with the Secretary of State. A **limited liability partnership** will revert to a general partnership upon voluntarily terminating limited liability partnership status, which is done by filing a withdrawal or termination statement with the Secretary of State. Limited liability partnerships do not expire unless the partnership fails to file the annual registration, in which case the limited liability partnership status is terminated and the partnership reverts to general or limited partnership status.

Note that the Revised Uniform Partnership Act (RUPA) also allows for mergers of partnerships which terminate all but the surviving partnership.

Corporation. The corporation is the most complex business form to terminate. Formal dissolution procedures, both before and after the issuance of shares, are specified by statute, and include, for example, filing notice of intent to dissolve the corporation and articles of dissolution with the Secretary of State, notification of creditors, disposition of assets, and distribution of the proceeds to shareholders. Tax consequences will affect both the corporation and its shareholders. Because of the complexity of the statutory procedures and tax implications, professional legal and accounting advice is highly recommended.

Corporations may end their separate existence by merging into another corporation or into a limited liability company.

Limited Liability Company. As is the case with partnerships, limited partnerships, and corporations, the procedures for dissolving a limited liability company, both before and after accepting contributions, are spelled out in the governing legislation. Different procedures apply, depending on when the limited liability company is dissolved and who dissolves it. The law specifies the notices to be given (e.g., to members and creditors), filings with the Secretary of State and procedures for winding up the business of the limited liability company.

Limited liability companies may end their separate existence by merging into another limited liability company or into a corporation.

Subsequent Reorganization or Change in the Tax Status of the Business. If the business is being terminated because the owner wishes to do business under a different type of entity (such as converting a sole proprietorship to an S corporation), special issues might need to be addressed. For instance, when an S corporation terminates its election and becomes a C corporation, adverse tax consequences often result. Likewise if the shareholders of a C corporation elect to have it taxed as an S corporation, it may be subject to adverse tax consequences requiring the corporation to be subject to various entity level taxes that can be significant. Also, certain assets of the business may not be transferable; for example, a contract that the business has entered into might or might not be transferable if the business is terminated and reorganized. Many other issues could arise when a business is terminated and begun again under a different form of organization. Although generally speaking an owner is permitted to change the form of his or her business at any time, a business owner is advised to seek professional assistance when considering changing the form of his or her business to avoid unintended consequences.

Extent of Government Regulation

Certain types of government regulation will apply to the business regardless of the form of organization. Licenses or permits will be required of all business entities conducting the regulated activity. Note that businesses operating in multiple jurisdictions (whether cities, states or counties) should inquire about licensing requirements imposed by each of those jurisdictions. This is equally true of businesses using the Internet. Federal, state and local consumer protection laws regulate business relationships with the public, without regard to the form of organization. Every business that hires employees will be required to comply with certain federal and state labor and tax laws governing the employment relationship. The following paragraphs identify the major differences in the extent of regulation for each type of business organization.

Sole Proprietorship. The sole proprietorship, as a form of business organization, is not generally regulated by the state. Other than tax filings and specialized reports applicable to certain kinds of businesses (e.g., hazardous waste generators), no special governmental filings or reports are required, making the sole proprietorship the least restrictive, most private form of organization.

Partnership. A **general partnership,** like a sole proprietorship, operates with relatively few governmental controls. RUPA provides statutory rules for basic questions of partnership management and relationships between the partners and third persons, but most issues are determined by the partnership agreement. No special partnership reports or filings with government entities are required, but an assumed name certificate may be required, depending upon the partnership name.

Limited partnerships, limited liability partnerships and **limited liability limited partnerships** must file with the Secretary of State on a yearly basis in order to retain their special status.

Corporation. Rules governing the corporation are established by laws of the state of incorporation and the corporation's articles of incorporation. These rules are more formal and complex than those governing partnerships and limited partnerships. In addition to complying with laws and regulations applicable to similarly situated businesses, any corporation that issues registered securities will be required to make periodic filings with state and federal regulators and must comply with other reporting requirements. Tax laws applicable to corporations generally are more complex than those applicable to proprietorships or partnerships and specific statutory procedures apply to dissolving the corporate entity. Most governmental filings are public documents, making the corporation the least private form of organization. An S corporation must meet specific requirements to qualify for S corporation tax treatment, and this status may be terminated when these requirements are not met.

Minnesota corporations must file an annual corporate registration with the Secretary of State which will provide corporations with a reminder-to-file notice. Failure to file an annual registration for two years will trigger administrative dissolution of the corporation.

Limited Liability Company. Rules governing the limited liability company are established by statute as well as the limited liability company's operating agreement and its articles of organization. These rules are similar in complexity to those governing partnerships and corporations.

TAX CONSIDERATIONS IN CHOOSING THE FORM OF ORGANIZATION

This section discusses the major tax considerations for the sole proprietorship, partnership, and corporation. For limited liability companies, the Internal Revenue Service has adopted rules (which appear in 26 C.F.R. 301.7701-1 et. seq.) that allow the organizer(s) to select the federal tax treatment for the LLC: either as a sole proprietorship or a corporation, (in the case of LLCs with only one member); or as a partnership or a corporation, (in the case of LLCs with at least two members). (The Minnesota Department of Revenue, in Revenue Notice 13-08, has stated that the Department of Revenue will for Minnesota tax purposes respect the choice made under the Federal Regulations). Because LLCs are treated as sole proprietorships, corporations, or partnerships, they are not specifically described in the following text. How a business is treated for federal tax purposes, is how it will be treated for Minnesota state tax purposes. Detailed advice on specific situations should be obtained from a competent tax advisor.

Considerations addressed in this section include:

- Who is the Taxpayer?
- What Tax Forms Are Used?
- Tax Rates
- Tax Impact
- Selection of the Tax Year
- Compensation for Services
- Employment Taxes and Workers' Compensation Insurance
- Employee Retirement Benefit Plans
- Fringe Benefits
- Capital Gains and Losses

- Net Operating Loss
- Estimated Tax Payments
- Disposition of Ownership Interest

Who Is the Taxpayer?

Sole Proprietorship. In a sole proprietorship, the taxpayer is the individual business owner. The proprietor is taxed on the entire net income from the business, regardless of whether the income is withdrawn for personal use or retained in the business. This is the case for both federal and Minnesota tax purposes.

Partnership. The partnership itself is not a taxable entity. The partnership serves as a conduit through which income, deductions and credits are passed through to the individual partners. Each partner is taxed on his or her share as defined in the partnership agreement. All income of the partnership is taxed to the partners, whether or not it is actually distributed. The partnership itself files an information return which reports partnership income and distributions to the partners. This is the case for both federal and Minnesota tax purposes.

Corporation. A corporation is a separate legal and taxable entity. For tax purposes, the corporation may be a "C corporation" (taxed under Subchapter C of the Internal Revenue Code and corresponding sections of Minn. Stat.) or it may elect to be treated as an "S corporation" (taxed under Subchapter S of the Internal Revenue Code and corresponding sections of Minn. Stat.). Both C corporations and S corporations file federal and Minnesota tax returns. In the case of a C corporation, the corporation itself is the taxpayer and pays tax on corporate profits. After taxes are paid any remaining corporate profits may be distributed to shareholders in the form of dividends. The shareholders are then taxed on the dividends they receive from the corporation. In general, an S corporation is taxed in a manner similar to a partnership; that is, the income, deductions and credits of the corporation are passed through to shareholders and are taxed to shareholders at their individual tax rates. These rules become more complicated in the case of an S corporation that was taxed as a C corporation at some time prior to electing to be taxed as an S corporation.

It is worth noting here that because a corporation is an entity separate from its owners, if the owner (and/or members of the owner's family) performs services for the corporation, these persons are considered to be employees of the corporation. Thus, the corporation will be required to comply with most of the laws and regulations and reporting requirements applicable to employers, including filing employment tax forms.

Note: It is possible that each of the above-listed entities, other than a sole proprietorship, may be subject to a Minnesota minimum fee. See the discussion of "Tax Rates," which follows after the discussion of "What Tax Forms are Used?"

What Tax Forms Are Used?

Note: Income tax forms identified here apply to the 2014 tax year. Amendments to the Minnesota tax laws and federal Internal Revenue Code may change these requirements.

Sole Proprietorship. Federal: The sole proprietor reports income and expenses from the business on Schedule C or Schedule C-EZ (Form 1040) and any related forms and schedules. The net income or loss from the business is then transferred to the proprietor's individual Form 1040. The sole proprietor uses Schedule SE to report net self-employment income for purposes of computing Social Security, Medicare and self-employment tax. **Minnesota:** There is no separate form for reporting proprietorship income. To compute Minnesota income tax, the proprietor uses Form M-1, the individual income tax form. A copy of the federal Form 1040, including a copy of Schedule C or Schedule C-EZ, plus Schedule SE, if appropriate, must be attached to Minnesota Form M-1. Minnesota does not impose a self-employment tax.

Partnership. Federal: The partnership files Form 1065, which is an information return. No tax is paid by the partnership with this return. Other forms and schedules may be required, including Schedules K and K-1. Individual partners use Schedule E (Form 1040) which is prepared with information from their Schedule K-1 of Form 1065, to report their distributive share of partnership income, deductions, credits and losses on their individual Form 1040. Schedule SE (Form 1040) is used to compute Social Security and Medicare self-employment tax. **Minnesota:** The partnership files Form M3 and taxes paid by the partnership with this return include: Minnesota Minimum Fee, Minnesota Composite Income Tax, and Withholding for Nonresident Partners (described in the Tax Rates section of the *Guide*). Schedules KPI and KPC are supplemental K1 type schedules used to report modifications to federal tax computations of partnership income and the other information a partner needs to complete the Minnesota individual income tax return, Form M-1. Schedule KC is used for computing the Minnesota Composite Income Tax (when the partnership pays the Minnesota income tax on behalf of nonresident partners). Schedule MW3NR is used for reporting the Withholding for Nonresident Partners. Minnesota does not impose a self-employment tax.

C Corporation. Federal: The C corporation reports its income, deductions and credits, and computes its tax, on Form 1120 or Form 1120-A. Supporting forms and schedules may be required. If the corporation issues dividends, it must annually send its shareholders Form 1099-DIV, stating the amount of dividends paid. A copy also is filed with the Internal Revenue Service and the Minnesota Department of Revenue. The shareholder reports dividends received from the corporation on his or her individual Form 1040. **Minnesota:** The corporation files Minnesota Form M-4. Dividends paid to shareholders are included in the shareholders federal taxable income reported to the Department of Revenue, Form M-1.

S Corporation. Federal: The S corporation files Form 1120S and supporting forms and schedules, including Schedules K and K-1 (Form 1120S). The S corporation generally is not separately taxed. Individual shareholders report their share of the S corporation's income, deductions and credits on their individual Form 1040, using information contained on the Schedule K-1. **Minnesota:** For Minnesota income tax purposes, the S corporation files Form M8. Taxes paid by the S corporation include: Minnesota S Corporation Taxes, (which apply only if the S corporation is paying federal income tax), Minnesota Minimum Fee; Minnesota Composite Income Tax; and Withholding for Nonresident Shareholders (see discussion in the Tax Rates section of the *Guide*). Schedule KS is a supplemental K-1 type schedule used for reporting modifications to federal income tax computations of S corporation income and the other information a shareholder needs to complete the Minnesota individual income tax return, Form M-1. Schedule KC is used for computing the Minnesota Composite Income Tax (when the S corporation pays the Minnesota tax on behalf of the nonresident shareholder). Schedule MW3NR is used to report the Withholding for Nonresident shareholders.

Tax Rates

The rate of tax paid on income from the business activity depends on whether the business is organized as a sole proprietorship, a partnership, an S corporation, a C corporation, or a limited liability company. Income from a sole proprietorship, partnership, S corporation, or limited liability company is taxed to the owner at individual tax rates. A C corporation's income is taxed to the corporation at corporate tax rates. Dividend income paid by the C corporation is taxed to shareholders at their individual income tax rates.

Federal Individual Income Tax Rates. Federal income tax rates for the 2015 tax year are 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, 35 percent, and 39.6 percent depending on income.

Net Investment Income Tax. A Net Investment Income Tax of 3.8 percent is imposed on the unearned income of individuals whose modified adjusted gross income exceeds $200,000 ($250,000 for married couple filing jointly.) For purposes of the tax, unearned income includes interest, dividends, most capital gains, and income from passive business activities.

Minnesota Individual Income Tax Rates. The anticipated Minnesota individual income tax rates are 5.35 percent, 7.05, 7.85, and 9.85 percent depending on income and filing status. Partnerships and S corporations that have nonresident individual partners or shareholders are allowed to file and pay using a composite income tax, on behalf of their nonresident partners or shareholders who do not have other Minnesota income, on the partnership's or S corporation's return. In this situation, the nonresident partners or shareholders do not have to file separate Minnesota individual income tax returns. The tax rate for the Minnesota Composite Income Tax is 7.85 percent of the individual's "Minnesota source" income. If a partnership or S corporation does not pay a composite income tax on behalf of nonresident individual partners or shareholders withholding tax at a rate of 7.85 percent must be paid from that individual's "Minnesota source" income, and submitted with the partnership's or S corporation's return. The partner or shareholder then files an individual income tax return claiming the tax paid by the entity on line 3 of schedule M1W.

Federal Corporate Income Tax Rates.

Taxable income over	Not over	Tax rate
$ 0	$ 50,000	15%
50,000	75,000	25%
75,000	100,000	34%
100,000	335,000	39%
335,000	10,000,000	34%
10,000,000	15,000,000	35%
15,000,000	18,333,333	38%
18,333,333	. . . .	35%

Personal Service Corporations are taxed at a rate of 35%.

Minnesota Corporate (Franchise) Income Tax Rates. The Minnesota corporate income tax rate is 9.8 percent. Corporations are subject to an alternative minimum tax based on Minnesota alternative minimum taxable income at the rate of 5.8 percent. The amount due is the excess of the alternative minimum tax liability over the firm's regular franchise tax liability.

Minnesota Minimum Fee Rates. A graduated minimum fee is imposed on Minnesota entities filing as corporations, S corporations, and partnerships. The minimum fee schedule is as follows:

Minnesota Payroll, Property and Sales	Fee
Less than $960,000	$ 0
$960,000 to $1,929,999	$ 200
$1,930,000 to $9,649,999	$ 580
$9,650,000 to $19,299,999	$ 1,930
$19,300,000 to $38,589,999	$ 3,860
$38,590,000 or more	$ 9,650

The minimum fee brackets and rates are adjusted annually to reflect changes in the consumer price index.

Phase in of Single Factor Apportionment Formula. Between 2007 and 2014, Minnesota is moving from a three factor apportionment formula (sales, property and payroll) to a single sales factor formula for purposes of a business apportioning its income to Minnesota for income tax purposes. The new formula for conversion from the three factor (sales, property and payroll) apportionment to the singles (sales) apportionment is:

Year	Sales % Factor	Property % Factor	Payroll % Factor
2014 and later	100	0	0

Tax Impact

Many factors determine the full tax burden on a business. Some of these factors – such as treatment of capital gains, deductibility of certain items, and the availability of certain credits – will vary depending on the form of organization. Other factors, such as employment taxes attributable to non-owner employees or property taxes, will apply regardless of the form of organization. For detailed analysis of these factors in the context of the specific business, a competent tax advisor should be consulted. The following paragraphs describe the major differences in tax impact attributable to the form of organization.

Sole Proprietorship. A sole proprietorship business in itself is not subject to tax. Instead the net income or loss from the business is combined with the proprietor's income and losses from other sources to determine the proprietor's income for tax purposes. The proprietor is taxed on the net income of the business, regardless of whether the income is withdrawn for personal purposes or retained in the business. Because income or loss from the business is combined for tax purposes with income and losses from other sources, the tax impact on income from the business may be different than if the business were taxed as a separate entity. However, because only the proprietor is taxed and not the business entity, distribution of the business profits to the owner are not subject to tax. Another consideration of the sole proprietorship compared with a C corporation is that not only the amount but also the character of various income items, deductions, and credits may be claimed by the business owner. In a C corporation, items are claimed by the corporation on its tax return and are not passed through to shareholders.

Partnership. Partnership income is taxable to the partners regardless of whether it is actually distributed or retained in the business. The partners report their distributive share of partnership income, deductions and credits on their individual income tax returns, where these items will be combined with income and losses from other sources. This income is taxed at the individual income tax rate applicable to that partner's tax bracket. The partners may allocate their distributive share of partnership income, deductions and credits for tax purposes in the partnership agreement. As long as there is "substantial economic effect" to the allocation (as defined by tax laws and Internal Revenue Service regulations), the partnership may offer greater opportunity for tax planning than the proprietorship or corporate form of organization. By "substantial economic effect" the Internal Revenue Service essentially means that the allocation made in the partnership agreement may actually affect the dollar amount of the partner's share of the partnership income or loss independently of any tax consequences. As with the proprietorship, both the amount and character of various income and deduction items are passed through to shareholders. However, certain deductions may not be permitted, certain items must be separately stated, and a partner's ability to claim his or her share of partnership losses generally is limited to the partner's adjusted basis in the partnership interest. (Basis is a way of measuring an individual's investment in property. **In the case of a partnership interest it generally starts with the amount of cash or basis of property contributed for the partnership interest (or the amount paid in the case of a purchase from another partner) and is increased by later contributions and income allocated to the interest and decreased by losses allocated to the interest and distributions. Basis also can be affected by the amount of partnership debt allocated to a partner for tax purposes. These rules can be quite complex and often should be discussed with competent advisors when a partner's tax basis is relevant.**

C Corporation. C corporations are legal entities and taxed separately from their owners. The C corporation's taxable income, and tax, are determined prior to distribution of profits to shareholders. Profits which are distributed to shareholders in the form of dividends are then taxable to the shareholders. Thus both the C corporation and the shareholder are subject to tax on their respective incomes. The dividends are taxed to the shareholder as ordinary income. The attributes of capital gains, charitable contributions and other income and deduction items end at the C corporation and do not retain their character when passed to shareholders in the form of dividends. Similarly, individual shareholders do not share a corporation's losses for tax purposes.

C corporations offer some opportunity for tax planning in that dividends may be accumulated by the corporation rather than distributed to shareholders. However, Internal Revenue Service regulations limit the amount of accumulated earnings that may be retained by the corporation. An accumulated earnings tax may be imposed on excessive accumulated earnings. Because all income of the sole proprietorship, partnership, and S corporation is taxable to the owners whether or not it is distributed, these entities are not subject to the accumulated earnings tax. The C corporation also may pay a salary to owner-employees. Salaries are deductible by the corporation and thus are not included in the corporation's taxable income. However, the Internal Revenue Service may treat excessive salaries as dividends and disallow that portion of the salary expense.

S Corporation. Like a partnership, the S corporation is a conduit through which the firm's income and deductions flow to the shareholders. Income items (including capital gains) and deductions generally retain their character when passed through to shareholders. Special reporting rules apply and the opportunity to fully claim a share of the S corporation's losses may be limited by passive activity or other tax rules as well as by the shareholder's tax basis in stock and in loans made by the shareholder to the S corporation. Unlike a partnership, allocations to S corporation shareholders must be in proportion to their shareholdings. Thus this form of organization may offer less attractive tax planning opportunities.

A shareholder's pro rata share of S corporation income and deductions is combined with income and losses from other sources and reported on the shareholder's individual income tax return. The total taxable income is taxed at individual income tax rates applicable to the shareholder's tax bracket.

Selection of the Tax Year

The business figures its taxable income and files a tax return on the basis of an accounting period called a tax year. A tax year usually is 12 consecutive months, although in some cases a 52-53 week year or a short tax year may be permitted. A **calendar** tax year is 12 consecutive months ending December 31. A **fiscal** tax year is either 12 consecutive months ending on the last day of any month other than December, or a 52-53 week year. To use a fiscal tax year, the business must keep its books on that basis. Once a tax year is established, the business generally may not change it without Internal Revenue Service approval. The application to change the tax year must show a substantial business purpose for the change, and that no significant tax advantage will result.

Sole Proprietorship. Like most individual taxpayers, sole proprietors generally use the calendar year as their federal and Minnesota tax year. The sole proprietor must report income from all sources on the basis of the same tax year.

Partnership. In general, the partnership must use the same tax year as the partners who own a majority interest in partnership profits and capital. If those partners have different tax years, the partnership must use the same tax year as its principal partners. Principal partners are defined by the Internal Revenue Service as those having an interest of five percent or more in partnership profits or capital. If the principal partners have different tax years, the partnership generally must use the calendar tax year. However, a partnership may adopt a fiscal tax year if it can establish to the satisfaction of the Internal Revenue Service that it has a business purpose for using a fiscal tax year. If a business purpose for using a fiscal tax year cannot be shown, a partnership that would otherwise be required to use a calendar tax year may in some cases elect a fiscal tax year by filing with the Internal Revenue Service Form 8716, Election to Have a Tax Year Other than a Required Tax Year. This election is called a "Section 444 election." A partnership that makes the Section 444 election must in some cases make a payment to the government that reflects the value of the tax deferral obtained by the partners as a result of the partnership's use of a fiscal tax year. A partnership uses the same tax year for both federal and Minnesota income tax purposes.

C Corporation. A C corporation establishes its tax year when it files its first income tax return. The first tax year must end not more than 12 months after the date of incorporation. A C corporation that is not a personal service corporation may choose a calendar tax year or a fiscal tax year, so long as the tax year selected does not distort income. This allows the corporation to establish a tax year in conformity with its natural business cycle. C corporations that are personal service corporations must use a calendar tax year unless the corporation establishes to the satisfaction of the Internal Revenue Service that it has a business purpose for using a fiscal tax year, or makes a Section 444 election.

S Corporation. S corporations must use a calendar tax year unless there is a business purpose for using a fiscal tax year and the Internal Revenue Service approves. If the S corporation cannot establish a business purpose for using a fiscal tax year, it may be eligible to make the Section 444 election described above. The corporation uses the same tax year for both federal and Minnesota tax purposes.

Compensation for Services

A business may use a variety of methods to compensate persons who provide services to it. Some of these methods include salaries or wages, personal draw, cash for services, and property for services. This section discusses the tax consequences of compensation for services provided by the owner of the business. Compensation to non-owner third parties, including the spouse or children of a sole proprietor, generally will be a deductible expense so long as compensation is reasonable and the services are necessary to the business.

Sole Proprietorship. A sole proprietor is not considered an employee of the business and does not receive wages or salary for tax purposes. A sole proprietor is subject to tax on the net income of the business as it is earned, regardless of whether it is withdrawn. Compensation for services or other amounts withdrawn from the business thus are considered withdrawals of income and are not again taxed at the time of withdrawal.

Partnerships. Like sole proprietors, partners of a partnership are considered to be “self-employed” and, as such, are not considered employees of the business and do not receive wages or salary for tax purposes. Amounts paid for services in a manner similar to salary or in the form of benefits that are not determined with respect to partnership income are taxed as “guaranteed payments” – ordinary income to the partner and deductible or capitalizable by the partnership depending on the nature of the payment. The partners also are subject to tax on their share of partnership income as it is earned, regardless of whether it is withdrawn. In the case of partners treated as “general partners” for federal income tax purposes, these amounts may be considered income from self-employment and may be subject to the tax on self-employment income. Typically distributions made to partners are not taxable unless they exceed the partner’s basis in his or her partnership interest.

C Corporations. Payments to owners: Payments to shareholder-employees in the form of salary or wages are deductible by the corporation in determining taxable income. As with other wages and salaries, these payments are taxed to the recipient as wage or salary income. Payments must be reasonable and the services must be necessary to the business. Compensation to shareholder-employees which is found by the Internal Revenue Service to be unreasonable may be reclassified as a dividend. This is to prevent using salary payments as a device to reduce corporate profits subject to tax.

S Corporations. Payments to owners: The payment of wages or salary to S corporation employees, including owner-employees, is deductible by the corporation in determining taxable income. These payments are then taxed to the recipient as wage or salary income. Payments must be reasonable and the services must be necessary to the business. The question of unreasonably large salaries to shareholder-employees of S corporations is not as important as it is in C corporations, because the S corporation generally pays no taxes at corporate rates. However, the Internal Revenue Service may challenge salaries which are used as a device to shift income to shareholders in lower income tax brackets. In addition, the cost of fringe benefits paid for employee shareholders who own more than two percent of the company's stock must be included in the income of the shareholder.

Note: Special rules apply to tax treatment of property, such as stock, received for services. Business owners contemplating such transfers should consult with their tax advisor prior to the transfer.

Employment Taxes and Workers' Compensation Insurance

Employment taxes include income tax withholding, Social Security and Medicare taxes and federal and state unemployment insurance taxes. Although workers' compensation insurance technically is not a tax, coverage is required for most employees. Employment taxes and workers' compensation insurance are deductible business expenses in determining net income.

Note: The following information on employment taxes and workers' compensation insurance applies only to businesses that have employees. Sole proprietors and partners that provide services to the business are not considered employees for purposes of paying unemployment taxes or obtaining workers' compensation insurance coverage for themselves. They may, however, be liable for Social Security and Medicare self-employment tax. (See the discussion of the self-employment tax below.) Shareholders in a C corporation or an S corporation who perform services for the corporation generally will be considered employees of the corporation and therefore will be subject to employment taxes. In most situations, workers' compensation coverage for these shareholders also will be required.

Self-Employment Tax. The self-employment tax (SE tax) is a social security and Medicare tax primarily for individuals who work for themselves. It is similar to the social security and Medicare taxes withheld from the pay of most wage earners.

You figure SE tax yourself using Schedule SE (Form 1040). Social security and Medicare taxes of most wage earners are figured by their employers, also, you can deduct half of your SE tax in figuring out your adjusted gross income. Wage earners cannot deduct social security and Medicare Taxes.

SE tax rate. The self-employment tax rate is 15.3 percent. The rate consists of two parts: 12.4 percent for social security and 2.9 percent for Medicare. An additional 0.9 percent is imposed on earnings from self-employment above a threshold amount of $200,000 for single and head of household filers; $250,000 for joint filers; $125,000 for a married person filing separately.

Maximum earning subject to SE tax. For 2016, only the first $122,700 of combined wages, tips and net earnings are subject to any combination of the 12.4 percent Social Security tax. All combined income is subject to the 2.9 percent Medicare part of the SE tax or Social Security tax.

Self-employed tax deduction. Half of the SE tax (excluding the additional 0.9 percent described above) can be deducted in figuring the adjusted gross income. The deduction only affects your income tax. It does not affect your net earnings from self-employment or your SE tax.

Social Security and Medicare Tax. The Social Security tax and Medicare tax are collected from both employers and employees. For 2015 the combined total Social Security and Medicare tax rate is 15.3 percent of the first $118,500 of wages paid. For 2016 the base is $122,700. These rates are, however, subject to Congressional action so employers should check with the Internal Revenue Service to confirm the correct rate. Additional Medicare Tax of 0.9 percent is imposed on earnings above a threshold amount of $200,000 for single and head of household filers; $250,000 for joint filers; $125,000 for a married person filing separately.

Social Security and Medicare taxes other than the additional 0.9 percent Medicare Tax are paid by both the employer and the employee. The additional 0.9 percent Medicare Tax is paid solely by the employee. The combined tax rate for 2016 for both the employer and the employee is 7.65 percent of the first $122,700 Social Security and Medicare taxes are not required for a sole proprietor's children under age 18 who work in the sole proprietorship.

Federal Unemployment Tax. Employers generally are liable for both federal and Minnesota unemployment taxes. The federal unemployment tax rate is 6.0 percent of the first $7,000 in wages paid each employee. A credit of up to 5.4 percent may be allowed for state unemployment taxes paid for a normal net tax of 0.6 percent. This credit is reduced during periods where the state unemployment insurance trust fund has borrowed from the federal treasury and has not fully repaid the loan. Wages paid to a spouse or child under age 21 who works in a sole proprietorship owned by the spouse or parent are not subject to federal unemployment taxes; other exceptions also may apply. (Editor's note: changes in state unemployment tax law may change your FUTA liability. Timely payment of state unemployment tax creates an offset credit on FUTA tax liability. Contact a tax advisor for more information.)

Minnesota Unemployment Tax. State unemployment tax rates are discussed in the business tax section of the *Guide*. Different rates apply to new businesses, the construction industry, and businesses which have an established experience rating. Wages paid by a sole proprietor for services performed by their parent, spouse or child under the age of 18 are not subject to Minnesota unemployment taxes. Wages paid to corporate officers or members of an LLC who own 25 percent or more of the corporation or LLC are not subject to Minnesota unemployment tax. Other exceptions also may apply.

Workers' Compensation Insurance. Workers' compensation insurance rates depend on the nature of the work performed by the employee and the employer's experience rating. A sole proprietor or partner may elect to obtain workers' compensation coverage for an employee who is a spouse, parent or child of the owner, but coverage for these family employees is not required. In addition, certain closely held corporations may elect coverage for executive officers who own at least 25 percent of the stock of the corporation.

Retirement Benefit Plans

Retirement benefit plans include qualified employee benefit plans, nonexempt trusts and annuity plans, self-employed retirement plans, individual retirement arrangements, and simplified employee pension plans. The tax treatment of contributions to these plans is highly technical; also there are frequent changes in tax laws that affect the treatment of those contributions. A business owner contemplating such a plan or making deductions for contributions to the plan should obtain the advice of competent counsel.

Note: Whenever the term "IRA" is used in the following paragraphs, generally speaking the discussion applies to both conventional IRAs and Roth IRAs.

Sole Proprietorship. A sole proprietor may establish and contribute to a Keogh retirement plan. Depending on the proprietor's adjusted gross income and net earnings from self-employment, he or she may open and contribute to an individual retirement account (IRA) in addition to or in place of the Keogh plan. Qualified contributions to the sole proprietor's own Keogh plan or IRA are deductible (with some exceptions) in determining the proprietor's adjusted gross income on Form 1040. Those contributions are not considered expenses of the business, however, and therefore are not deductible in computing net income from the business on Schedule C. Minnesota generally follows IRS rules in the tax treatment of Keogh and IRA contributions. A sole proprietor who has employees may establish a qualified retirement plan for the employees. Contributions to the plan, if they meet IRS requirements, are deductible from business income reported on Schedule C.

Partnership. Like sole proprietors, working partners in a partnership may contribute to a Keogh plan established by the partnership. They also may open and contribute to an IRA if they meet income limitations for such contributions. Qualified contributions by each partner may be deducted (with some exceptions) in computing their individual adjusted gross income on Form 1040. Contributions by or on behalf of partners to their own retirement plans are not deductible from partnership income. Minnesota generally follows IRS rules. Retirement plans which are established for employees must comply with Internal Revenue Service requirements. Contributions to qualified plans on behalf of employees are deductible business expenses.

Corporation. Generally, contributions by the corporation to qualified pension plans and qualified profit sharing plans will be deductible by the corporation. The plan must be approved by the Internal Revenue Service.

Note: Master and prototype retirement plans may be available to the business. In many cases, it will be easier to use these samples rather than setting up a new plan. Master and prototype plans may be sponsored by trade or professional organizations, banks, insurance companies, or regulated investment companies. These entities usually will have applied for, and received, an IRS opinion letter on the plan. Using one of these master or prototype plans does not mean that the plan is automatically qualified. The plan still must meet all IRS requirements. However, the master or prototype may offer a firm some guidance in developing its own plan.

Fringe Benefits

Fringe benefits include items such as accident and health insurance, medical savings accounts, group term life insurance, salary continuation plans, reimbursements for educational expenses, dental insurance, death benefits, day care programs, supplemental unemployment benefits, "cafeteria plan" programs, and others. As with employee retirement benefit plans, the tax treatment of fringe benefits is a highly technical area. Accordingly, it is recommended that the advice of competent counsel be obtained prior to structuring such plans.

The following paragraphs discuss the tax treatment of providing fringe benefits to owners of the business. The cost of providing fringe benefits to employees generally will be a deductible business expense if reasonable in amount and in compliance with federal and state tax codes and other statutory requirements. In some cases the benefits may be taxable to the employee and subject to income tax withholding.

Sole Proprietorship. Sole proprietors generally may not deduct as a business expense the cost of obtaining fringe benefit items for themselves, although items such as day care for the proprietor's children may be eligible for a tax credit if they otherwise meet IRS requirements. For federal tax purposes sole proprietors may deduct up to 100 percent of the cost of medical insurance premiums paid for themselves, assuming IRS requirements are met. Note that this issue is frequently the subject of legislation in Congress, so anyone affected should monitor developments.

Partnership. Partners of a partnership (including members of a limited liability company that is taxed as a partnership) are considered self-employed individuals, and are subject to the same rules on deductibility of fringe benefits as sole proprietors.

C Corporation. The C corporation may deduct the cost of providing fringe benefits to employees, including shareholder employees. To be deductible, the fringe benefit plan must meet requirements of the federal and state tax laws, including nondiscrimination in favor of executive or highly compensated employees. Employee health plans also must comply with applicable state statutory requirements to be deductible for Minnesota income tax purposes.

S Corporation. An S corporation may deduct the cost of providing fringe benefits that it pays to all employees, including shareholder employees. However, the cost of fringe benefits paid for employee shareholders who own more than two percent of the company's stock must be included in the income of the shareholder. Typically, this is reported on the shareholder employees' Form W-2 in addition to their normal salary.

Capital Gains and Losses

A business that sells or otherwise disposes of capital assets will have a capital gain or capital loss from the transaction. Capital assets are defined by Internal Revenue Service regulations and generally include everything a business owns except property held for sale to customers, most accounts or notes receivable, real and depreciable personal property used in the business, copyrights and similar intellectual property, and certain government publications.

Sole Proprietorships, Partnerships, and S Corporations. Capital gains realized by these entities are taxed to the owners at the rate applicable to the owner. In the case of an individual the maximum federal income tax rate applicable to long term capital gains (on capital assets held more than one year) is 20 percent for 2015. Individuals with an adjusted gross income in excess of $200,000 and married couples with an adjusted gross income in excess of $250,000 and filing jointly will also pay a 3.8 percent Net Investment Income tax on most capital gains.

Federal long-term capital gains tax rates for 2015 and future years are as follows:

- 0 percent applies to long-term gains and dividend income if a person is in the 10 percent and 15 percent tax brackets,
- 15 percent applies to long-term gains and dividend income if a person is in the 25 percent, 28 percent, 33 percent, or 35 percent tax brackets, and
- 20 percent applies to long-term gains and dividend income if a person is in the 39.6 percent tax bracket.

C Corporation. A corporation's capital gains are taxed at the corporation's regular tax rate. Thus the maximum federal tax rate on a corporation's capital gain is 35 percent. A corporation may deduct capital losses only up to the amount of its capital gains. If a corporation has a net capital loss, the loss cannot be deducted in the current tax year but instead must be carried to other tax years and deducted from capital gains that occur in those years. This is the case for both federal and Minnesota tax purposes.

Net Operating Loss

If the taxpayer's deductions for the year exceed gross income, the taxpayer may have a net operating loss (NOL). The NOL is used to reduce taxable income in other years. There are limits on the kinds of deductions, and the amounts, that can be used in computing an NOL. These limits are different for individuals and for corporations and for federal and Minnesota returns. For C corporations, if the NOL is attributable to business carried on both in and outside Minnesota, a computation allocating a portion of the NOL may be required on the Minnesota return.

Sole Proprietorship. The NOL is determined on the proprietor's gross income from all sources as reported on the Form 1040, not just on the income or loss from the business reported on Schedule C. In general, an NOL is computed in the same way taxable income is computed: deductions are subtracted from gross income, and if deductions exceed gross income there is a net operating loss. However, there are rules that limit what deductions may be taken in computing an NOL. In general, these rules do not permit a deduction for net capital losses, nonbusiness losses, nonbusiness deductions, personal exemptions and NOL carryovers or carrybacks from previous years. Some deductions also must be modified in taking the NOL. Internal Revenue Service regulations and those of the Minnesota Department of Revenue determine the years to which the NOL is carried, and the order in which NOLs are deducted.

Partnership. A partnership is not allowed to take an NOL deduction. All losses to the partnership for tax purposes are passed through to the partners each year. The partners may use their separate shares of the partnership's loss to compute their individual NOL. The rules for sole proprietors discussed above apply.

C Corporation. For federal tax purposes, a C corporation determines and deducts an NOL in much the same way an individual does. The same carryback and carryover periods apply and the same rules apply when two or more NOLs are carried to the same year. A corporation's NOL differs from an individual's NOL in three ways. First, a corporation is allowed to take different deductions in figuring an NOL. Second, a corporation must make different modifications to its taxable income in the carryback or carry forward year when figuring how much of the NOL may be deducted. Third, Minnesota does not permit carryback of an NOL. (An NOL may be carried forward 15 years.) Because the corporation is a separate taxable entity, the NOL is deducted by the corporation and is not passed through to shareholders. Minnesota's tax laws must be followed in taking the NOL deduction for Minnesota income tax purposes.

S Corporation. The S corporation, like a partnership, is not allowed to take an NOL deduction. If the S corporation incurs a loss for the year, it is passed through to shareholders in proportion to their shareholdings. The shareholders of the S corporation may use their share of the corporation's loss to compute their individual NOL.

Estimated Tax Payments

Sole Proprietorship. The sole proprietor generally will be required to make federal and Minnesota estimated tax payments if his or her income tax and (for federal purposes) self-employment tax will exceed taxes paid through withholding and credits by $1,000 or more. The tax is determined on income from all sources, including income from the business. A penalty may be imposed on underpaid estimates.

Partnership. The partnership itself is not required to make estimated tax payments. However, for Minnesota tax purposes, a partnership is required to pay quarterly estimated tax if its Minnesota minimum fee is $500 or more or if it has a nonresident partner whose share of the composite income tax is $500 or more. As with the sole proprietorship, individual partners generally will be required to make estimated tax payments if their income tax and self-employment tax will exceed taxes paid through withholding and credits by $1,000 or more. The tax is based on taxable income from all sources, not just the income from the partnership. If the tax is underpaid, a penalty may be imposed on the partner. As with the sole proprietorship, both federal and Minnesota estimates generally will be required.

C Corporation. Federal: A C corporation whose estimated tax is expected to be $500 or more is required to make estimated tax payments using the Electronic Federal Tax Payment System (EFTPS). **Minnesota:** A corporation with an estimated tax of $500 or more must make Minnesota quarterly estimated tax payments. In addition, a C corporation with more than $10,000 in tax liability must make all its tax payments via electronic funds transfer. These payments are filed with the Minnesota Department of Revenue. For both federal and Minnesota purposes, a penalty may be imposed for failure to pay the correct estimated tax on or before its due date.

S Corporation. The S corporation is not subject to estimated tax on income which passes through to shareholders. For Minnesota tax purposes, an S corporation is required to pay quarterly estimated tax if its S corporation taxes and minimum fee is $500 or more or if it has a nonresident shareholder whose share of the composite income tax is $500 or more. A penalty may be applied if the estimated taxes are underpaid.

Disposition of Ownership Interest

Sole Proprietorship. The sole proprietor who sells the business is treated as selling the individual assets of the business. The income tax treatment of the sale will depend on whether or not the property is a capital asset, and the length of time the property has been held. The assets may also be subject to state sales tax. A sole proprietor also may change the form of the business without selling its assets, such as by joining with one or more persons to form a partnership or a corporation, and then transferring the assets of the sole proprietorship to the new organization. The tax consequences of such a transfer should be discussed in advance with a competent tax advisor.

Partnership. The sale or exchange of a partner's interest in a partnership ordinarily results in capital gain or loss on the difference between the amount realized and the adjusted basis of the partner's interest in the partnership. **The partner's share of partnership debt is taken into account as well. If a partner sells or exchanges the partner's entire interest in a partnership, the partner generally is treated as if the partner received a cash distribution in an amount equal to**

the partnership debt allocable to the interest. Special rules apply to exchanges of an interest in one partnership for an interest in another, liquidation of a partner's interest, and the treatment of unrealized receivables and inventory items. Tangible assets sold as part of the transaction also may be subject to state sales tax. Because of the complexity of the tax laws affecting the disposition of a partnership interest, the tax consequences of such a disposition should be thoroughly explored in advance with a competent tax advisor.

Note also that under the Revised Uniform Partnership Act (RUPA), mergers of partnerships are allowed. Again, because of the complexity of tax laws, a competent tax advisor should be consulted when considering a merger of partnerships.

Corporation. Disposition of an ownership interest (shares of stock) in a corporation must be distinguished from liquidation of the corporation. Individual shareholders who sell their stock generally will recognize capital gain or capital loss on the sale of their shares. The gain or loss will be long term or short term, depending on the length of time the shares were held. An interest in a corporation also may be disposed of by complete or partial liquidation of the corporation. In liquidation, the corporation may either dispose of its property for cash, and distribute the cash to its shareholders, or it may distribute its property to the shareholders in exchange for the corporation's capital stock held by those shareholders. In either case, the distribution generally will result in capital gain or capital loss to the shareholders. Tangible assets sold as part of the transaction also may be subject to state sales tax. In some cases, the timing of the transaction may affect the tax consequences. The tax consequences of corporate liquidations and stock redemptions for both C corporations and S corporations and their shareholders can be complex. For this reason, it is advisable to consult with a competent tax advisor prior to attempting to liquidate the corporation or dispose of corporate assets.